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The Economy: Treading on Thin Ice, Perception or Reality? 2001

Maine State Planning Office

Laurie G. Lachance
Maine State Planning Office

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The Economy:

Treading on Thin Ice Perception or Reality?

By Laurie Lachance



Although the past nine years have been ones of tremendous growth for both the U.S. and Maine economies, today the economy shows signs of weakening. Consumer confidence has taken a nosedive; recent stock market activity has been sluggish; and, nominal oil prices since 1999 have nearly tripled. Moreover, Maine has its own set of cautionary signs: the multiple job-holding rate in Maine is 25% higher than it is in the United States; bankruptcy filings remain alarmingly high—as do personal debt levels. 🐉 In this “status of the economy” article, State Economist Laurie Lachance discusses these trends and the implications they may hold for Maine’s future. Despite today’s warning signals, she concludes that—on balance—the outlook for the future is decent. In short, perhaps what we face is vulnerability, not disaster. 🐉

INTRODUCTION

The past nine years have been a period of tremendous prosperity for both the U.S. and Maine economies. Nationally, the near decade-long expansion has broken records and the pace of economic growth has actually accelerated through the late 1990s and into 2000. Inflation rates and jobless rates have plummeted to historic lows; the stock market has surged, lining the wallets of individuals and companies alike; and windfall tax collections have reversed the fortune of the previously beleaguered national treasury, leaving many state coffers overflowing. By all accounts, Maine has been riding this wave of national prosperity, and it has been quite a ride indeed.

However, as the year 2000 drew to a close, the U.S. economy showed definite signs of weakening. Consumer confidence took a nosedive, bringing automobile sales and seasonal retail activity with it. As the year 2001 began, the economic signals continued to flash warning signs. Is the economy moving toward a recession, or is this just our perception shaped and darkened by daily headlines of doom and gloom? Pundits assert that the risk of a downturn is the highest it's been in this business cycle, and yet the typical conditions that lead to a recession are not present. There is little doubt that the consumer has the power to bring this economy to its knees, but one must wonder if the pessimism being expressed by Americans is justified or irrational.

To assess the likely path of economic growth going forward, I will first examine the national economic condition and outlook, then look at

Figure 1:
(a) U.S. Real GDP Growth; (b) U.S. CPI Growth;
(c) U.S. Unemployment Growth

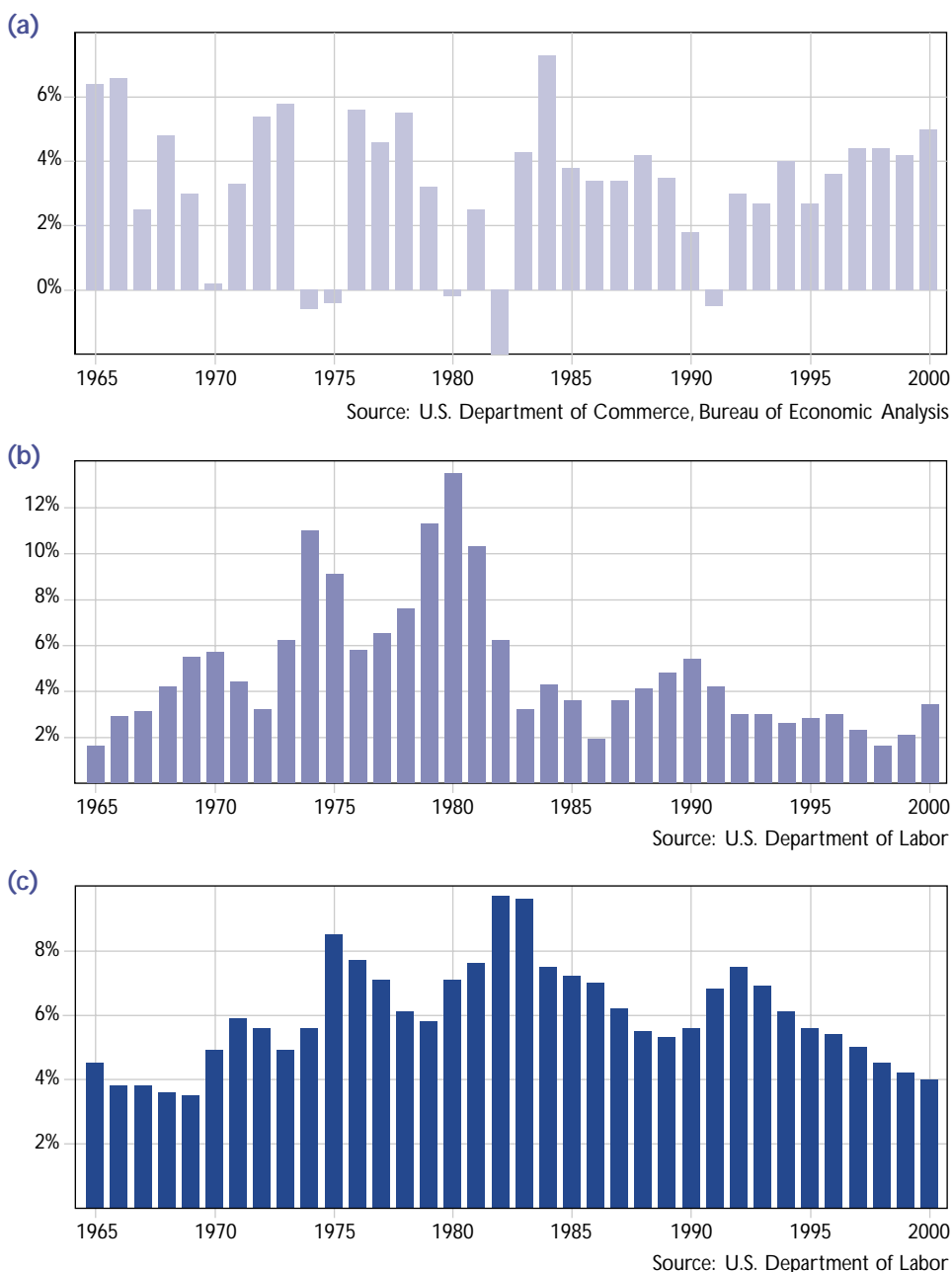
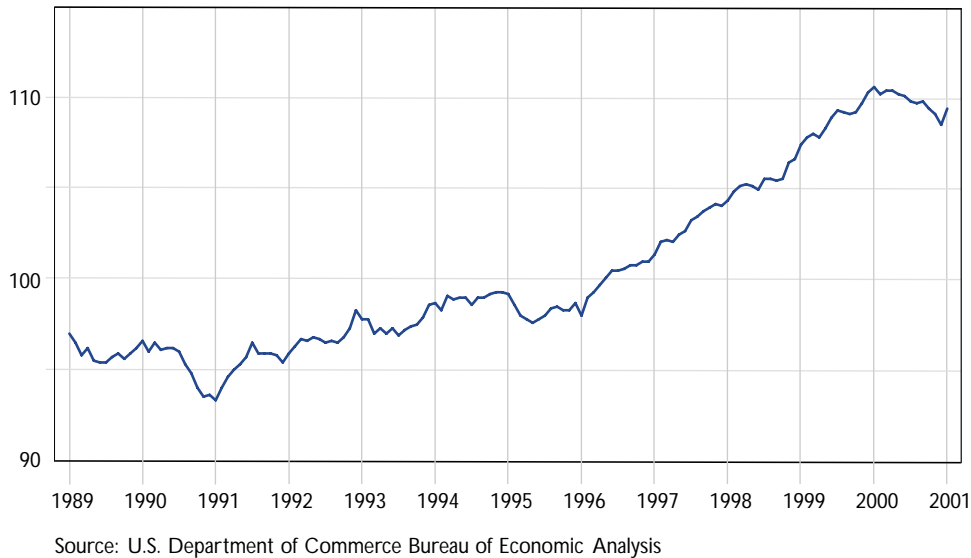


Figure 2:
U.S. Index of Leading Economic Indicators (1989-2001)



Maine's economy and the forces shaping our growth. Finally, I will assess areas of vulnerability and share the forecast for Maine.

NATIONAL ECONOMY

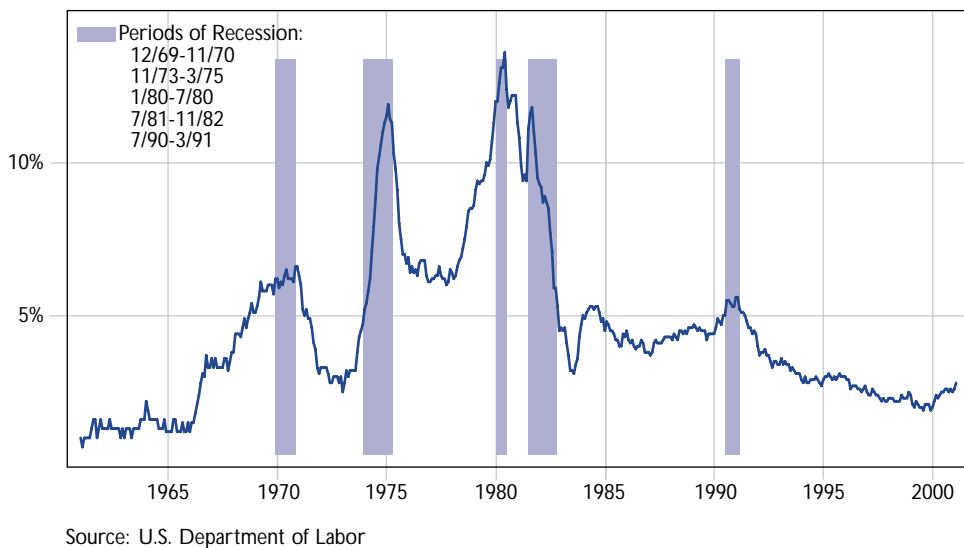
U.S. GDP, CPIU and Unemployment

The United States is enjoying the longest economic expansion of the post-World War II period. The exceptional nature of our current economic position is illustrated by Figure 1 (see previous page). Real Gross Domestic Product (GDP) growth for 2000 hit 5%, capping a nine-year expansion. It is also worth noting that real GDP grew in excess of 4% for four consecutive years, and that the United States has not seen such a sustained, high-growth period in over three decades. Inflation has been a non-factor of late, remaining below 3.5% for nine straight years, which is virtually unheard of. And the national rate of unemployment continued its descent from a 1992 peak of just under 8% to a rock-bottom 4% for 2000, which is the lowest jobless rate since 1969. By every major measure, the national economy has been enjoying good health.

U.S. Index of Leading Indicators

Now the questions become: When will this end? Are we at a turning point? How far will we fall? Although a recession is virtually impossible to predict, there are several potential warning signs that can be examined. A quick look at the U.S. Index of Leading Economic Indicators surely gives us some insight. Without a doubt, the U.S. economy is weakening, as is evidenced by the steady drop in

Figure 3:
Core Inflation (year-over-year percentage change)



the leading indicators throughout the year 2000. In fact, according to the March 12, 2001 issue of *BusinessWeek*, a 3.5% drop in this index over a six-month period is an excellent predictor of an oncoming recession. As Figure 2 shows, the index was rapidly closing in on this trigger before taking a turn for the better in January. While upward movement in the index of leading economic indicators may temporarily allay fears of imminent recession, the future remains uncertain.

Core Inflation

Another indicator that may provide insight into future economic activity is the core inflation rate. (The core rate represents inflation in the prices of all consumer goods and services except food and energy, which tend to be very volatile.) The last five recessionary periods have been preceded by a spike in core inflation. As Figure 3 shows, the core inflation rate has been dropping for ten straight years. At this point, even with the recent rise to 2.8%, this indicator does not seem to be giving reason for major concern.

U.S. Consumption

Perhaps consumers are jittery? As the consumer accounts for two-thirds of GDP, major retrenchment in consumer spending could signal trouble. Until the end of 2000, consumers appear to have been anything but jittery. In fact, Americans have been on a major shopping spree and consumer spending has been accelerating over the past few years, settling at a robust level of 5% for 2000. It is certainly true that holiday spending was far below retailers' expectations and automobile sales have plummeted, but what is less certain is whether this recent display of frugality is a true curbing of our spendthrift ways or a temporary break in the action. The three interest rate cuts in early 2001 have given rise to a surge in refinancings; how Americans choose to use this new-found cash is currently in question. The early signs

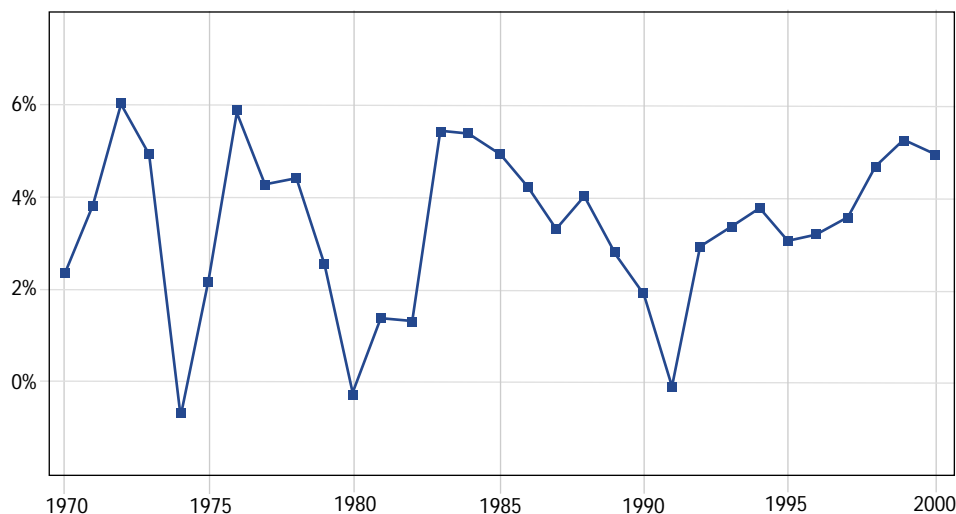
point toward using this cash to resume spending rather than to pay down debt, but how this plays out remains to be seen.

U.S. Personal Savings Rate

Finally, a quick look at the U.S. personal savings rate will tell you that there aren't a lot of folks saving for a rainy day. Savings rates dropped from 10% in the 1970s and 1980s to an estimated -0.1% during 2000. Granted, participation in the stock market through 401k plans and mutual funds has grown sharply through this same period of time, but the common man's access to liquid assets has dramatically dropped. Should the economy begin to slide, the realization by many that extremely high debt levels and extremely low savings rates have left them ill-equipped to deal with a downturn, may hasten the economic descent.

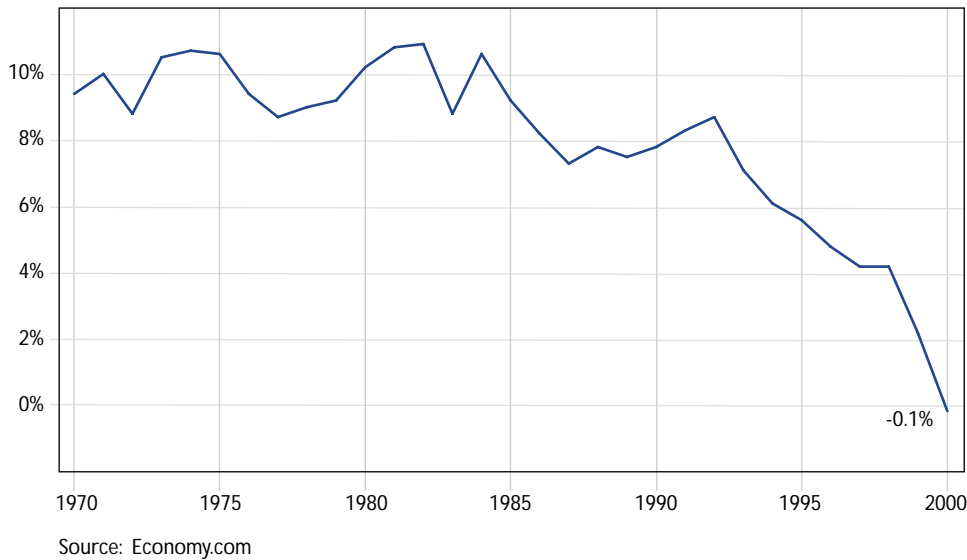
To summarize the U.S. economic condition and outlook, it appears that the wave has crested and is beginning to subside. However, a slowdown in growth—albeit painful—is not a recession. Barring any major

Figure 4:
U.S. Real Personal Consumption
(annual rate of change)



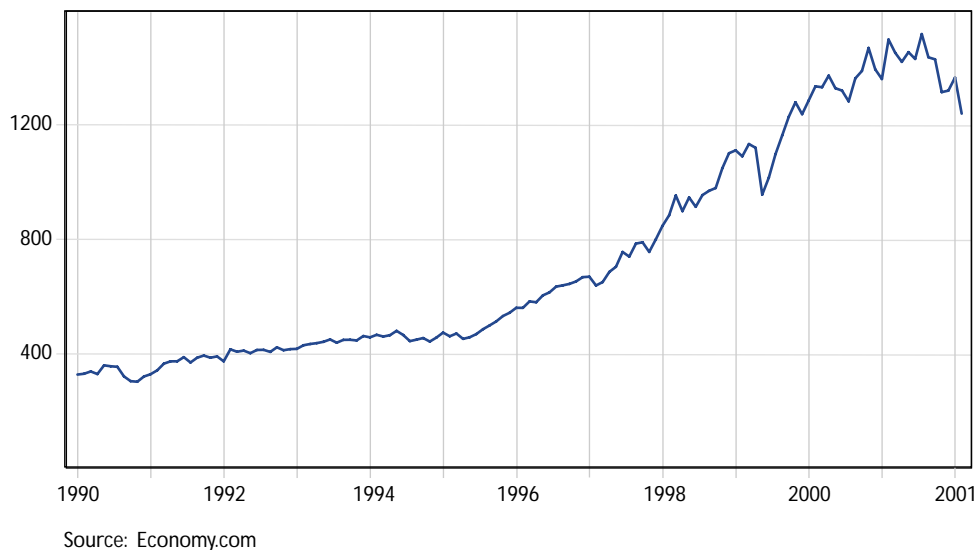
Source: U.S. Department of Commerce, Bureau of Economic Analysis

Figure 5:
U.S. Personal Savings Rate



shocks, the U.S. economy will continue to grow, but at about half the pace of 2000, as GDP growth is expected to slip to 2% for 2001 before modestly improving to the 3%-3.5% range thereafter. In an effort to create a soft landing, the Federal Reserve Board has lowered interest rates three times in the first quarter of this year and stands ready to reduce further if necessary. While forecasters assign a 70% probability to this "slow-growth" scenario, it is important to recognize that there are two wild cards that pose considerable risk to this soft landing—each of which has been problematic of late, and each of which has had an influence on the ever-important confidence of the American consumer.

Figure 6:
S&P 500 Index



S&P 500 Index

The first wild card is stock market activity. Over the past two decades, Americans have become increasingly involved with the stock market, which is no longer a rich man's game. Exceptionally strong markets through much of the late 1990s have created a euphoria of sorts, leaving folks feeling wealthy and confident. Analysts estimate that for every dollar in increased portfolio value, the average investor spends five cents, the so-called "wealth effect." But some fear that recent stock market activity may turn the "wealth effect" into the "wealth defect." From its peak in March of 2000, NASDAQ had tumbled 50% by year-end and the S&P 500 had fallen 14%. If markets get back on track, the United States may avert major consumer retrenchment. However, an ongoing slump could wreak havoc with both wealth and confidence going forward.

Figure 7:
U.S. Oil Price (dollars per barrel)
Domestic West Texas Intermediate

Oil Prices

The other wild card is oil prices, whose spikes have caused the last four recessions. Since 1999, nominal oil prices have nearly tripled. Given the convergence of energy markets, the upward surge in oil prices has put pressure on other forms of energy as well. In fact, natural gas prices have experienced a five-fold increase over the past two years, and price and reliability issues in California have put national electric markets under scrutiny and strain. Despite the fairly rapid run-up in oil prices, it is important to put our current situation in some historical context and to recognize that, in real terms, today's prices remain far below 1980 levels (see Figure 7). That said, OPEC's announced reductions in production are still worth watching closely, as is ongoing turmoil in the Middle East.

In summary, while the U.S. economy is undoubtedly in the most vulnerable position of this past decade, the baseline forecast calls for overall growth in the 2%-3.5% range; for the inflation rate (CPIU) to be slightly over 3% for 2000; below 3% thereafter; and for the unemployment rate to creep up toward 5%. If the wild cards are somehow tamed and consumer confidence remains buoyant, national growth should continue.

MAINE ECONOMY

Maine Wage & Salary Employment

Mirroring the nation, Maine's economic performance has been stellar. After struggling to regain its footing during the deep and protracted recession of 1990 and 1991, Maine's

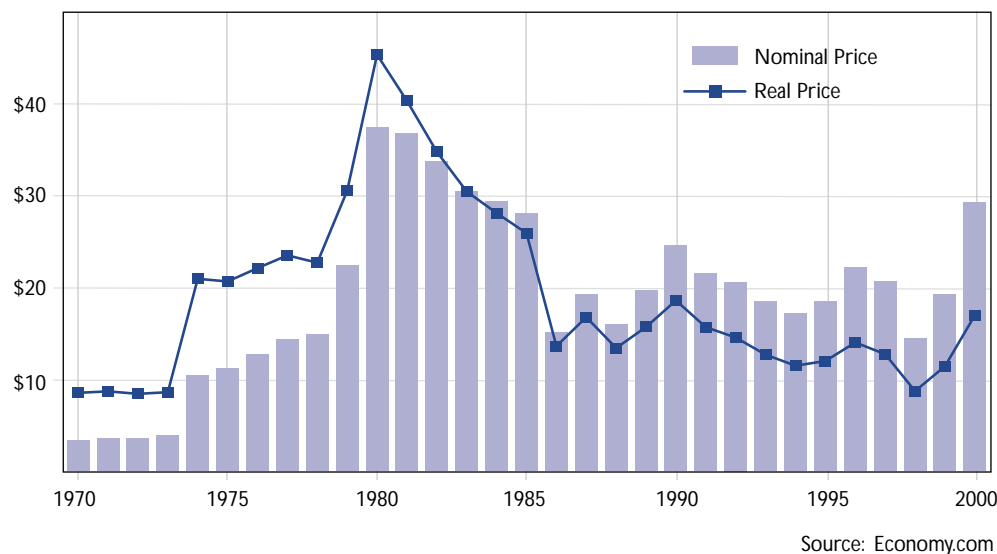


Figure 8:
Maine Wage & Salary Employment
(seasonally adjusted 1,000s)

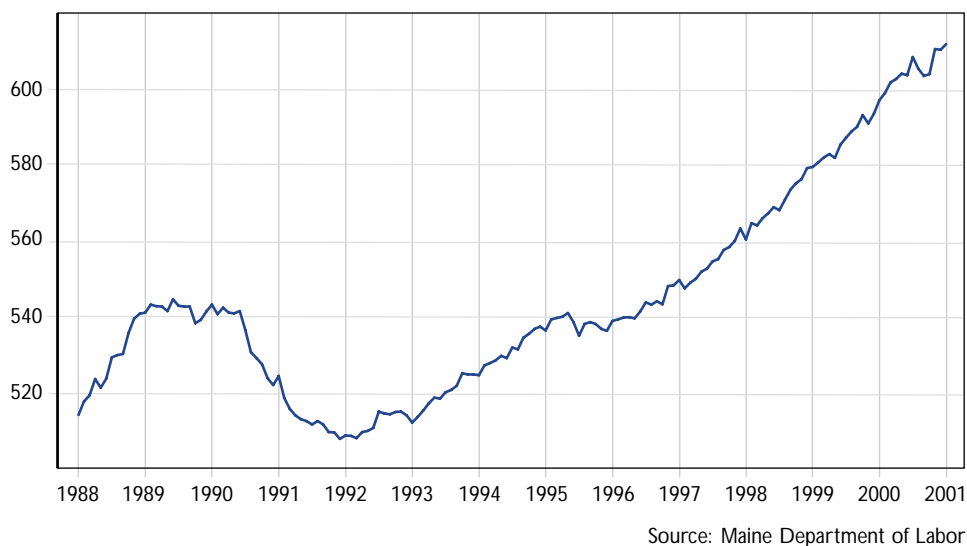
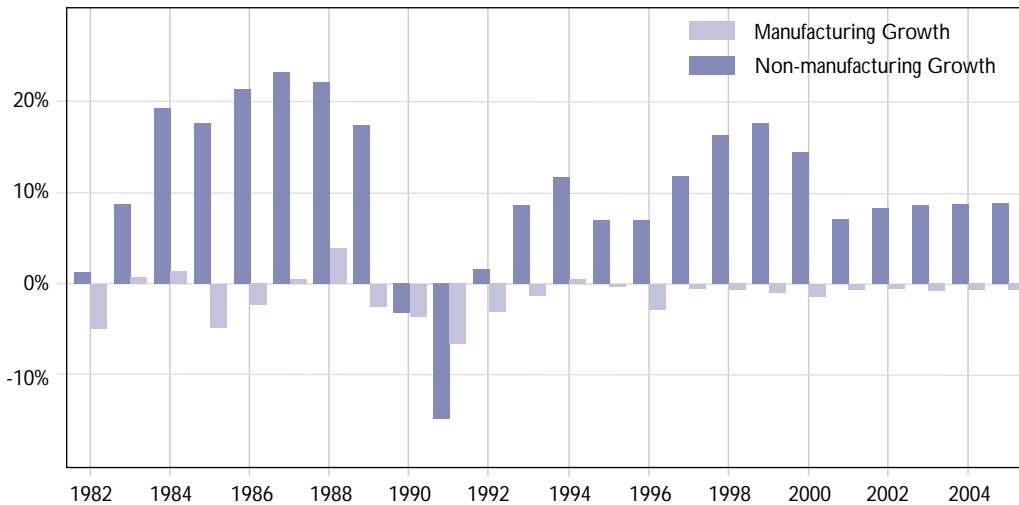
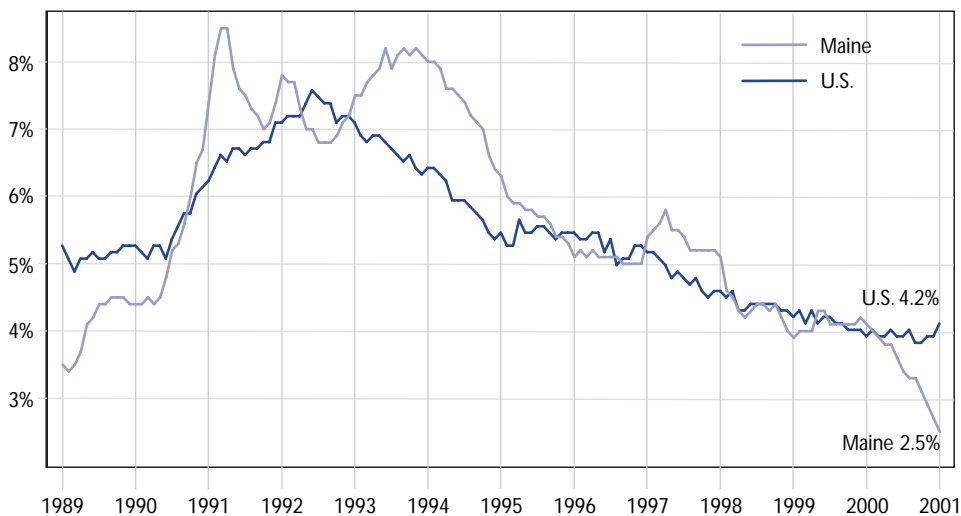


Figure 9:
Maine Payroll Employment (annual growth)



Source: Maine Department of Labor

Figure 10:
Unemployment Rates; Maine & U.S. (seasonally adjusted)



Source: Maine Department of Labor

economy gingerly began to walk through the mid-1990s before accelerating to a full sprint at the close of the decade. Now, the recession of 1990-1991 is a distant memory. Employment has grown near 3% for three straight years, which is fairly astounding given slow population growth and tight labor markets throughout the period. Maine has added fifty thousand jobs since 1998 and fully one hundred thousand jobs since the recession. Employment growth in Maine has closely tracked the performance of New Hampshire and Vermont, which have each seen a 15% expansion of their job base since the last business peak. The southern-tier states of Massachusetts, Rhode Island and Connecticut have been hard-pressed to expand job opportunities over the past decade as their current employment levels are barely 5% higher than the 1989 peak.

Maine Payroll Employment—Annual Gains

Not surprisingly, virtually all job gains have been in the non-manufacturing sector, which now provides nearly 85% of all wage and salary jobs. In fact, nine out of the top ten private employers in Maine are in the service sector, including two huge retailers, three hospitals, two grocers, an insurance company and a credit card company. Despite overall strong economic conditions, manufacturing job losses persist. The forecast calls for a continuation of these trends, with two-thirds of all job

Figure 11:
Maine County Unemployment Rates, 2000

creation coming from the medical, professional and business services sectors; a sizable portion from trade; and some job gains in construction. Maine's manufacturing sector is expected to endure continued pressure from foreign competitors, leading to minor job erosion through the forecast period.

Unemployment Rate—Maine & U.S.

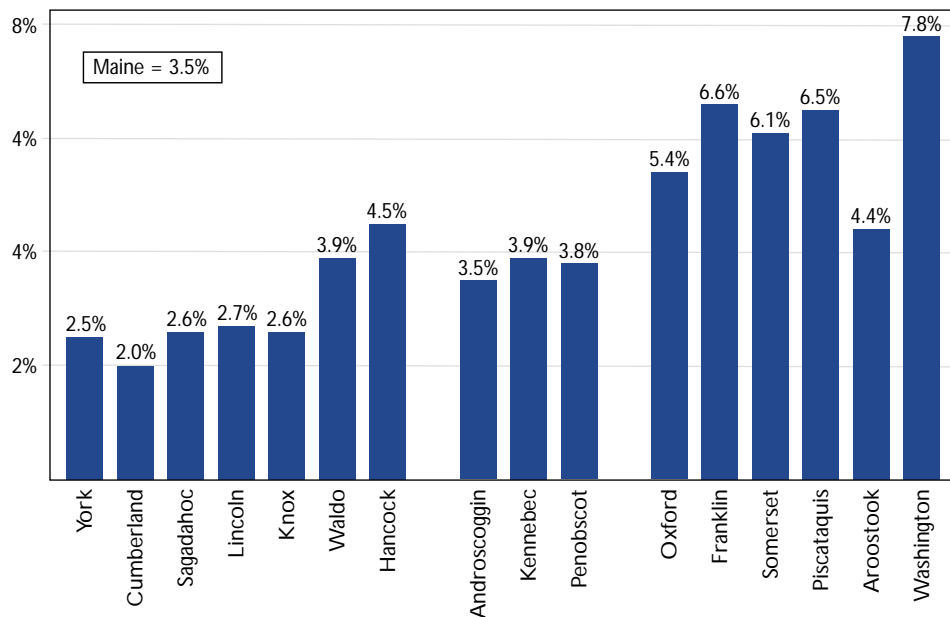
As a result of significant job growth, unemployment rates have plummeted. Help wanted advertising lineage has doubled in five years. Maine's jobless rate is at a fraction of its 1991 peak and, as of early 2001, is well below the U.S. rate.

Unemployment by County

Although rates of unemployment have fallen throughout the state, some areas of relatively high unemployment persist. It is no surprise that the highest rates are in the rim counties, which include the western mountain region, Aroostook and Washington counties. These six counties have a high concentration of natural resource-based jobs, which tend to be more seasonal in nature and lead to higher overall jobless rates. The stunningly low rates in the southern coastal region have created major headaches for employers in that area as finding labor is now their number one issue.

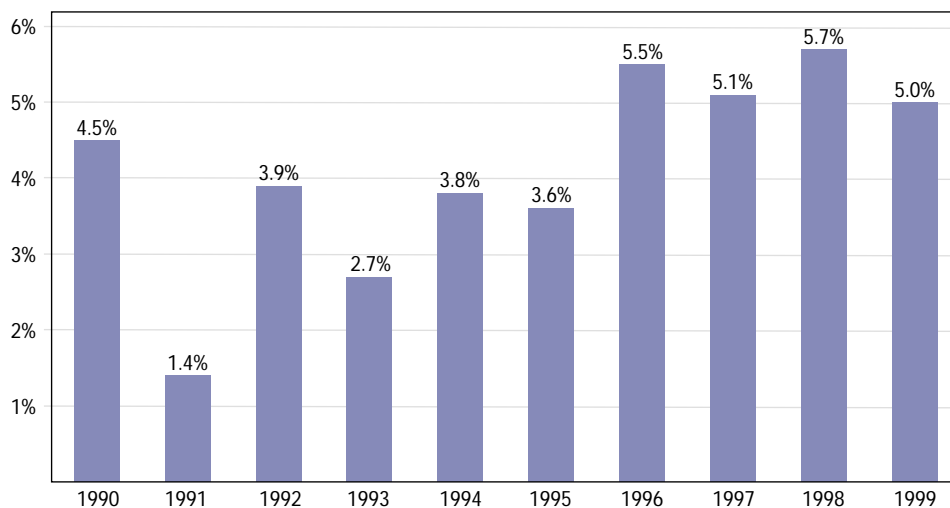
Maine Personal Income Growth

The bullish stock market, strong economy and low unemployment have translated into solid income gains for Mainers. Following the paltry performance in the early to mid-1990s, income growth for the past four years has averaged 4.5%-5%, stopping our free fall in the national rankings, allow-



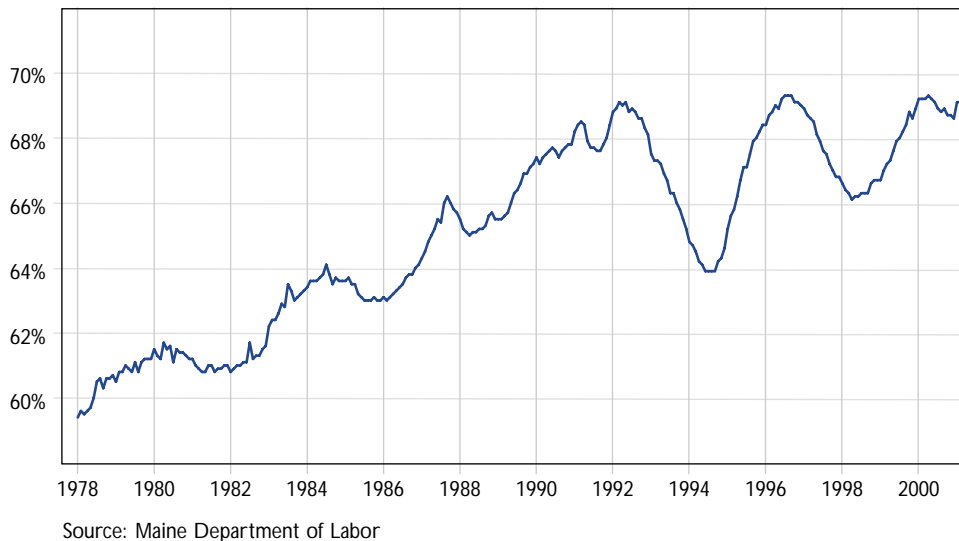
Source: U.S. Department of Commerce, Bureau of Economic Analysis

Figure 12:
Maine Personal Income Growth



Source: U.S. Department of Commerce, Bureau of Economic Analysis

Figure 13:
Maine Labor Force Participation Rate
 (civilian labor force as a percentage of population sixteen and over)



ing us to hold on to thirty-sixth place. The vibrancy of recent income gains has led to a surge in both consumer confidence and retail sales. Retail expenditures in Maine grew by a hearty 9% in 1998 and 1999 before slowing to a little over 3% in 2000. Given Maine's highly progressive tax structure, state income and sales tax collections have been exceptionally strong.

While it can easily be said that Maine is in the best economic condition since the glory days of 1989, like the rest of the United States, there are some areas of vulnerability worth watching.

Labor Force Participation Rates

Maine's labor force participation reached an historic high near 70% during the late 1990s. Employers are now finding it exceptionally difficult to find labor. The extreme tightness of the labor market is highlighted by billboards offering \$12 per hour for pizza delivery jobs, and benefits and retirement plans for sandwich shop employees. Tales of work-hour reductions and even closures have been told as employers grapple with the shortages. The Maine Metal Products Association reports that there are over two thousand well-paying jobs currently unfilled, and that companies in that industry have gone to fairly desperate measures to attract workers including signing bonuses and full educational payments. In the health care industry, shortages of nurses have become critical. Some hospitals are bringing in nurses from Canada to relieve some of the pressure. Continued labor market tightness will shape Maine's future; indeed, if we are unable to supply appropriately skilled labor to our key

Figure 14:
Multiple Job Holding Rate; U.S. & Maine

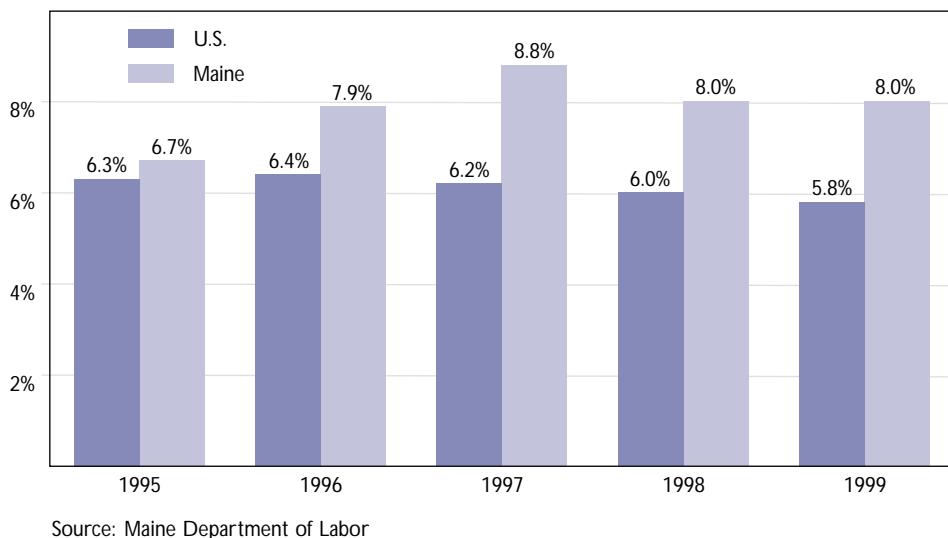


Figure 15:
Maine Bankruptcy Findings (twelve-month moving total)

industries, we may choke on our own success. Given projections of slow overall population growth, finding ways to raise the skills of Maine's current workforce to their highest levels could be an effective strategy for relieving the pressure.

Multiple Job Holding Rate

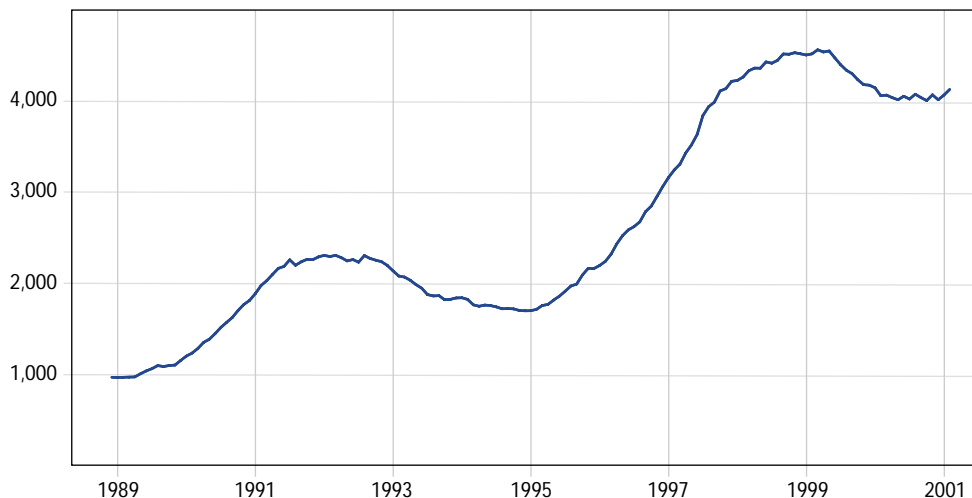
While opportunities abound, there remain some nagging questions about job quality. Maine is clearly at the peak of its business cycle, and yet its multiple job holding rate has risen through the most prosperous years and is now 25% above the U.S. rate. Why must 8% of Maine's workers hold more than one job at any given time to make ends meet? This trend forces us to examine more closely the type of jobs that are being offered in Maine and the level of benefits, particularly health benefits, that go along with these new job offerings.

Maine Bankruptcy Findings

Despite recent improvement, bankruptcy filings remain four times higher than the last business peak. Granted, bankruptcies in Maine have closely tracked national trends. However, that's cold comfort given the fact that as we entered the last recession, the filing rate grew by nearly two-and-a-half times in a very short time period. Our current staggering levels, which are predominantly driven by personal bankruptcies, again point to an area of vulnerability in our economic base and beg the question, "What happens in the next recession?"

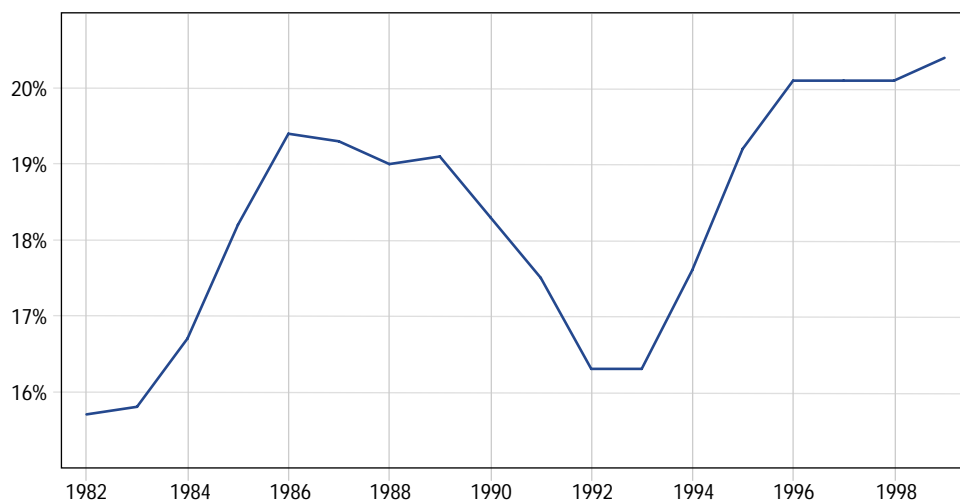
Maine Personal Debt Levels

Mainers continue to show a tremendous willingness to take on



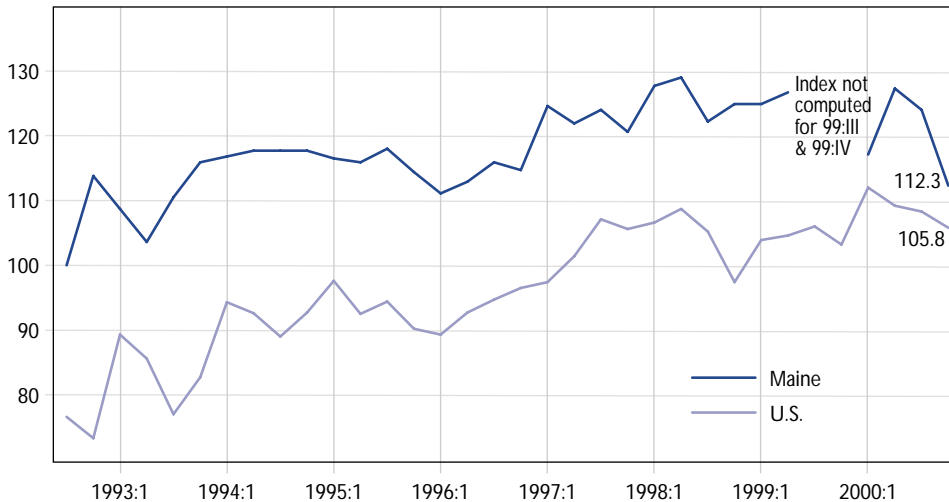
Source: U.S. Bankruptcy Court

Figure 16:
Maine Personal Debt Levels
(credit outstanding as a percentage of disposable income)



Source: Economy.com

Figure 17:
Consumer Confidence

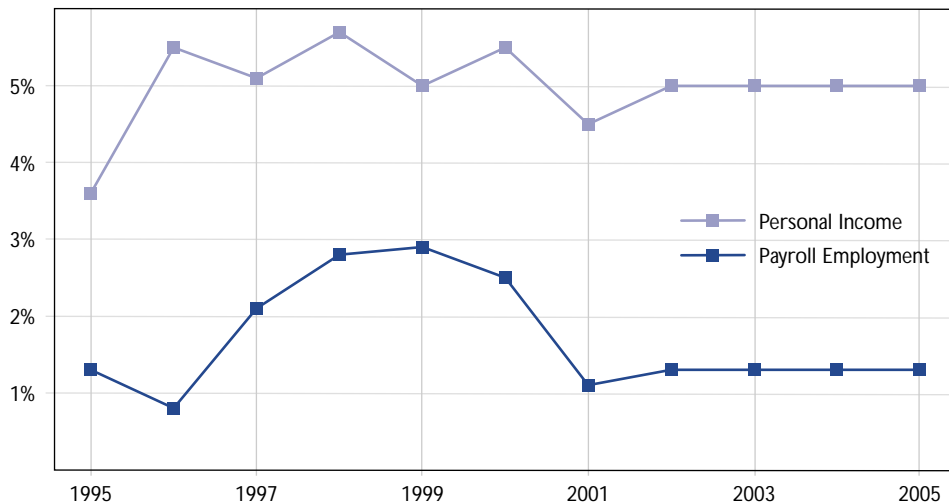


Source: Market Decisions, Inc. & The Conference Board

debt. Credit outstanding as a percent of disposable income grew from 16% in 1992 to 21% in 2000. Absent a major shift in the pattern of financing purchases, the forecast calls for a continuation of this trend in the near future, as debt levels among Mainers move toward 23%. Along with income growth and stock market performance, debt levels should start to play an increasing role in household purchasing decisions, particularly when it comes to expensive items such as real estate. As mentioned earlier, the wave of refinancings that have come about as a result of interest rate drops provide the perfect opportunity to pay down personal debt, and yet the early signs suggest that individuals have found other ways to use this new-found cash.

So, let's put the puzzle pieces together for Maine to see what all this means:

Figure 18:
CEFC Maine Forecast of January 2001



Source: Maine Consensus Economic Forecasting Commission

- Both the nation and the state have enjoyed several years of red-hot growth;
- Labor markets are so tight, they are starting to constrict growth;
- Consumers have overextended, as consumption has grown nearly twice as fast as income;
- Debt levels are very high and growing;
- Bankruptcies are extremely high and savings rates are extremely low;
- Eight percent of Maine's workers are working at least two jobs to preserve the lifestyle of the late-1980s.

Now, add to this a significant drop in stock market activity, and suddenly the “wealth effect” that has fueled spending patterns and filled state government coffers threatens to become the “wealth defect.” And if that’s not enough, add a 50% increase in heating oil prices to a state in which 75% of all households use some form of petroleum product with which to heat. As things start to come into focus, what you see is a picture of vulnerability, not disaster.

Consumer Confidence

This vulnerability manifests itself through a drop in consumer confidence and an abrupt slowdown in big-ticket purchases. Car sales in Maine grew 12.5% in the first quarter of 2000, 4.8% in the second quarter, 1.8% in the third quarter, and fell by 2.4% to finish the year. Building supplies followed suit, slowing from an explosive 17% increase during the first quarter to 14%, 5.8% and, finally, a paltry 0.2%. Does this mean recession for Maine? No, but it does mean the state cannot take much more pressure or much in the way of a shock.

SUMMARY

The Outlook for Maine

So, is Maine’s economy treading on thin ice? The short answer is yes, but we needn’t panic at this point. Undoubtedly, the risk of breaking through the ice and slipping into a recession has never been greater during this business cycle. That said, Maine’s economy is not nearly as overweight and bloated as it was in 1989. Virtually 100% of the region’s financial institutions are profitable and non-performing loans remain at very low levels, meaning our financial underpinnings are far stronger than they were a decade ago. The rampant overbuilding and speculative real estate ventures that characterized the 1980s are far less an issue right now. Our largest employers, who had dramatically overstaffed during the last expansion, have been unable to fill “essential” jobs during this period of growth much less the “would-be-nice” positions of yesteryear. With the exception of some noticeable bloating in the area of personal debt, Maine’s economy is leaner, meaner and more diverse, leaving us far better able to

tread lightly.

One thing that has become clear in recent years is that Maine’s economy is much more closely tied to the U.S. economy than ever before. This means that our near-term economic growth will depend, in large part, on national performance. Absent a shock that sends the U.S. economy into a slump, Maine’s economy will continue to grow, but at a slower rate. Slow population growth, high labor force participation levels, and extremely low unemployment rates will constrict job growth from 3% to the 1.3% level. Income growth will slow slightly, but tight labor markets will keep gains in the vicinity of 5%. In all—a decent outlook. 🐾



Since 1993, Laurie Lachance has served as Maine's state economist. She is responsible for managing all aspects of the economics and energy policy teams at the State Planning Office, and serves as an advisor to the director and state-agency department heads on the economic aspects of public policy formulation in Maine. Prior to 1993, Ms. Lachance worked as an economist for Central Maine Power Company.